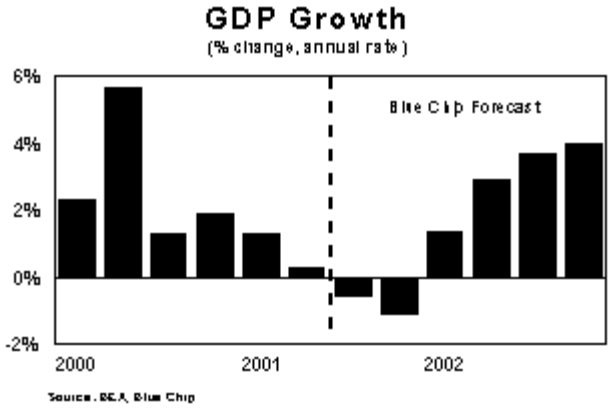
OCTOBER 2001

US OVERVIEW

The US economy is in a recession that probably started before September 11. At present the consensus view among economists is for the recession to last through the end of 2001 after which the economy will recover and expand in 2002. The unemployment rate, now at 4.9%, appears headed for about 6% by next spring with much of that increase expected by year end. The consensus view is that inflation is near a bottom and is set to gradually rise in 2002. However, the pattern of inflation during previous recessions and recoveries suggests it is poised to reach lows not seen since the early 1960s. Long-term interest rates should follow inflation downward despite potential budget deficits in the near future.

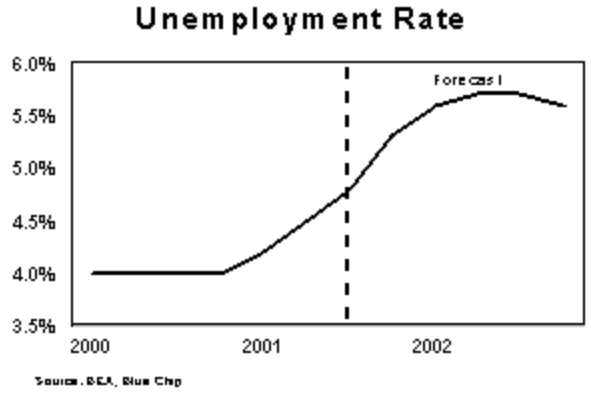
US Expansion Comes to an End

The US economy grew at only a 0.3% annual rate in the second quarter. Future benchmark recalculations of GDP may well revise this to a negative figure. Hours worked were falling at about a 3% rate in the third quarter even before September 11. The consensus among Blue Chip economists is that the economy will shrink at a 0.6% rate in the third quarter and a 1.1% rate in the fourth quarter. Given data on hours, construction, and shipments of capital goods, these forecasts could appear optimistic. In 2002, the Blue Chips have growth accelerating to a 4% rate by year end.



Unemployment Set to Rise

The recession is accelerating the pace of job losses. The jobless rate was 3.9% as recently as October 2000. It is now 4.9% and heading toward 6%. The Blue Chip forecast is for the jobless rate to peak at a quarterly average of 5.7% in the second and third quarters of 2002. One way to estimate likely changes in the jobless rate is to apply Okun's Law, named after economist Arthur Okun. Okun's Law suggests the unemployment rate should rise 1 percentage point for every 2 percentage points by which actual GDP growth falls short of "potential" GDP growth for a full year. For example, if the economy grows 2% for a year when long-term

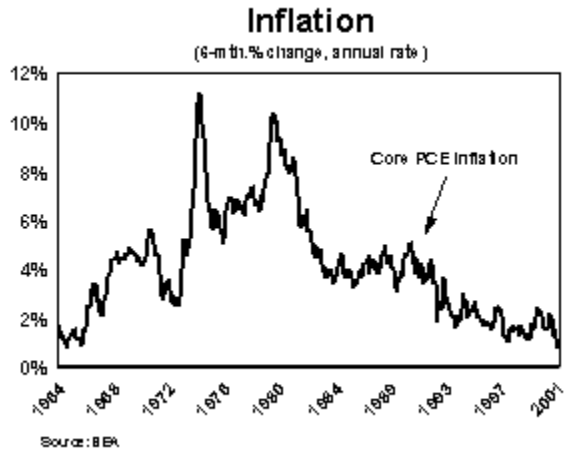


productivity growth and labor force growth indicate it has the potential to grow 4%, the jobless rate should rise by 1 percentage point.

Applying Okun's Law to the Blue Chip forecast – and using the Blue Chip 3.25% long-term growth trend as potential – suggests the jobless rate should average 5.4% in the fourth quarter and peak at a 5.7% average in mid-2002. Watch the Conference Board's measure of consumer confidence in the present economic situation to see if this forecast is materializing. Since 1988 there has been an extremely close inverse relationship between the 4-month average of consumer confidence and the jobless rate one month later. To get a jobless rate of 6%, consumer confidence will have to fall to the 80-85 range based on this relationship. Confidence was 125.2 in September.

Inflation Is Headed Lower

Chairman Greenspan's favorite inflation indicator is price changes for core personal consumption expenditures. Core PCE prices have increased 1.5% in the past year and have risen at only a 0.9% annual rate in the past 6 months, the slowest since 1964. Oil prices, which are not directly part of the core index, are down $7 per barrel since January ($5 of that since September 11). Barring a spike in energy prices, these already low inflation rates appear likely to fall further. In the past four recessions and recoveries, the year-to-year core PCE inflation rate has fallen by an average of 1.4 percentage points from 4 months before the end of the recession to 7 to 9 months into the recovery. A drop of 1.4 points from the current 1.5% rate would put core PCE inflation at 0.1%. To put this in perspective, the lowest recorded year-to-year inflation rate for core PCE was 0.9% in 1961.



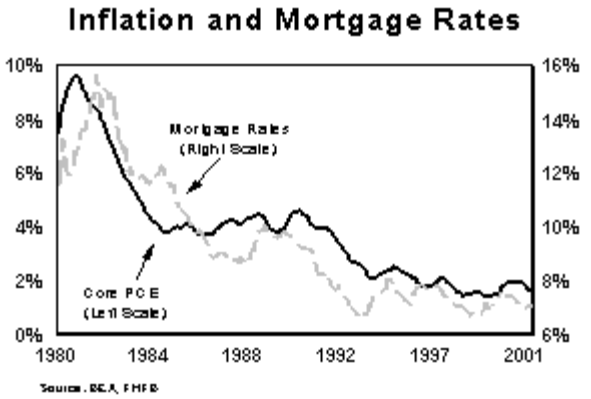
Recessions and Inflation

Recession	Pre-Recovery*	Recovery Low
1973-75	9.5	6.5
1980	9.0	8.8
1981-82	6.9	5.3
1990-91	4.5	3.8
2001	1.5	?

Source: BEA, SBC Calculations
*4 months prior to end of recession (core PCE y/y)

Long-Term Rates to Follow Inflation Lower

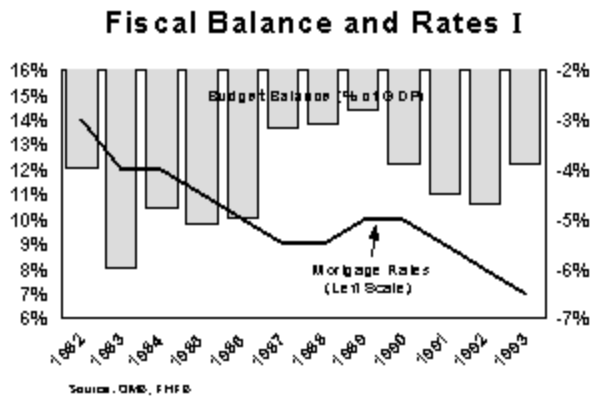
Lower inflation should lead to lower private sector interest rates despite the potential reappearance of budget deficits. As the adjacent chart shows, there is a strong long-term relationship between inflation and mortgage interest rates. In theory, budget deficits could lead to higher interest rates because they leave less loanable funds available to the private sector, thereby "crowding out" private investment. However, there are at least two problems with the "crowding out" theory and the evidence does not support it.

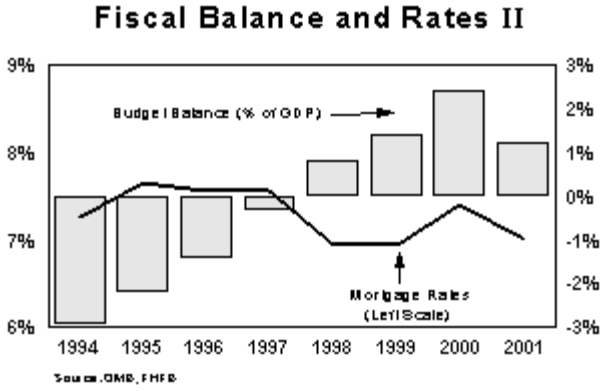


First, a portion of the extra funds borrowed by the federal government come from funds that would otherwise have been lent abroad, not to the US private sector. Foreign investors own about 42% of US Treasury debt held outside of US government accounts (such as the Social Security Trust Fund) and the Federal Reserve. If they did not hold US Treasury securities many of these foreign investors might prefer to hold German government debt, for example, rather than US private sector debt.

Second, to the extent the federal government runs budget deficits, taxpayers tend to increase their private savings in anticipation of the higher future taxes needed to finance extra government debt. The increase in private savings raises the amount of loanable funds available for private investment, offsetting the increased demand for funds by the federal government and bringing interest rates back down. In effect, taxpayers see the financial condition of the federal government as an extension of their own financial condition. When the federal government increases its debt, taxpayers offset this change by reducing their own debt; when the federal government cuts its debt, taxpayers adjust by taking on more debt themselves.

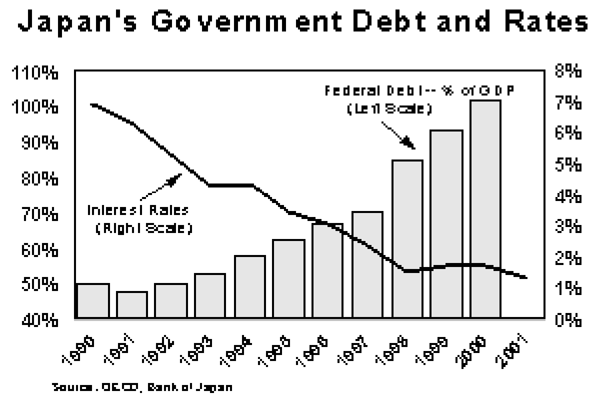
As the adjacent charts show, large budget deficits as a share of GDP in the 1980s and early 1990s coincided with a long-term decline in interest rates. In fact, the only time mortgage rates ceased falling was during a period when the deficit was shrinking as a share of GDP. Since 1994 interest rates have bounced up and down as the federal government has eliminated deficits and run budget surpluses.

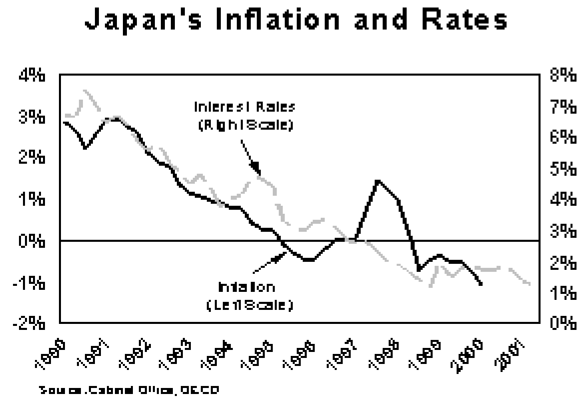




The current economic situation in Japan provides another example of how expectations about inflation (and deflation) trump government budget deficits in determining interest rates. Since 1990, Japanese government debt

as a share of GDP has increased from 50% to more than 100% as long-term interest rates have declined from 7% to less than 1.5%.





Does this mean deficits don't matter? Of course not. If deficits accumulate to an unsustainable level, in which lenders assume the Federal Reserve will have to monetize the extra debt to the point where it increases inflation, interest rates will rise. At present, that appears highly unlikely. Assuming nominal GDP growth is a very slow 2.5% in Fiscal Year 2002, the federal government could run a deficit of about $65 billion without increasing publicly-held federal debt as a share of GDP.

Key Economic Indicators

Quarterly Indicators (Q/Q, at annual rate)

	Q3-00	Q4-00	Q1-01	Q2-01
Real GDP Growth	1.3	1.9	1.3	0.3
Consumption	4.8	3.2	3.0	2.6
Business Investment	7.1	1.0	-0.2	-14.6
Trade Deficit ($ billions)	87.3	100.3	96.0	88.3
PCE Inflation	2.4	1.9	3.2	1.3
Productivity Growth	1.4	2.3	0.1	2.1

Monthly Indicators

	Jul	Aug	Sep
Unemployment	4.5	4.9	4.9
Payroll Growth	18K	-34K	-199K
CPI Inflation (yr/yr)	2.7	2.7	N/A
Retail Sales Growth (yr/yr)	3.3	3.7	0.2
Corporate Rates (Baa)	8.0	7.9	8.0
Federal Funds Rate (Month End)	3.75	3.50	3.00
Dow (Month End)	10.5K	9.9K	8.8K